Opinion **The Long View**

Consultants' claims and the evasion of responsibility

'Safety in numbers' mindset contributes to investment herding

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Few things in life are harder, but more necessary, than to take responsibility for our actions.

It is only human to try to evade responsibility for difficult decisions, particularly when our careers might depend on it. The problem is that when nobody takes responsibility, bad decisions can flourish.

This is the critical problem, in my view, for today's capital markets. That in turn makes it a critical problem for capitalism, which relies on capital markets to allocate capital wisely.

The best known example of the problem was the power unwittingly vested in credit rating agencies. Regulations steered fund managers into credits with a certain minimum quality.

Banks knew that the amount of capital they had to hold as a buffer depended on the rating the agency gave to the credits they held.

The result was that fund managers left all judgment to credit quality to the agencies, while trying to bamboozle the agencies into granting higher ratings than many securities deserved.

To a lesser extent, there is a similar problem with index providers. The decision over whether Chinese A-shares are suitable for mainstream western investment institutions has been outsourced to MSCI, the indexing group. Asset managers have not decided this themselves.

In both cases, the human tendency towards herding, going along with the crowd, was reinforced. Responsibility passed to a small group of people. Any group that takes on the role of helping investors to avoid the responsibility for their actions automatically becomes a weak point in the financial system.

All of this is a preamble to explain why I am concerned by the role of some of the apparently dullest companies in the market ecosystem — investment consultants and consulting actuaries. The trustees of pension funds are the owners of large pools of assets, but are often investment laypeople and need professional help. There is a need for investment consultants.

Now the problems start. Mergers have left only a handful of huge firms to choose from. The consultants are less advisers, and more crutches to lean on, or shields to hide behind.

Just as it used to be said that nobody got fired for buying IBM, so these days no pension fund trustee gets fired for hiring Mercer (or one of the other big names that dominate the sector). And the bigger consultants now also have their own asset management businesses, which creates an evident risk of conflict of interest.

And it also turns out that the advice the consultants give is not that good and, crucially, not as good as they present it as being.

This week, the UK's Competition and Markets Authority provisionally decided that the consultants did not split off their asset management businesses, while the Financial Conduct Authority (FCA) is asking for more authority to oversee consultants.

An academic paper by Gordon Cookson of the FCA, the Oxford university academics Tim Jenkinson and Howard Jones, and Jose Vicente Martinez of the university of Connecticut used data that six consultants (including three of the world's biggest consulting groups) had given to the FCA from 2006 to 2015 to evaluate their performance.

Damningly, the investment products that consultants recommend had exactly the same return and risk profile as products that the consultants had advised against.

The only significant difference is that the products they recommend tend to deviate less from their benchmarks. This implies a "safety in numbers" mindset among consultants that contributes to investment herding.

Overall, the three big consultants (which are unnamed) claimed that their recommended products did better than their benchmarks by 1.73 percentage points per year, a huge difference once compounded for a few years. However, they all used different methodologies, and did not make the underlying data available to clients.

Using data the consultants provided to the FCA, the academics did their own analysis, and found that over the 10 years, the recommended products made 5.4 per cent per year before fees

(or 5.11 per cent after fees). This was 0.3 percentage points *lower* than the universe of products that the consultants had not recommended.

When the academics compared the recommended products only to non-recommended products that were in the same category — so that they were looking at the consultants' ability to find good managers, and not at their ability to choose asset classes — they still found non-recommended products coming out ahead by 0.2 percentage points.

The academics also found that the consultants' claims for their recommended products' performance had been exaggerated to the tune of 1.95 percentage points per year.

So the damning conclusion is that the small band of consultants who guide a huge chunk of the public's pension money have no skill in identifying good fund managers and are not as good as they think they are.

This is not because of fraud, but because they have too much leeway in presenting their figures.

For example, one discrepancy arose because managers were compared to benchmarks that they had themselves chosen — and they often deliberately choose benchmarks which will be easy to exceed. Comparison to the universe of non-recommended products, surely the critical test, rendered a very different result.

We need investment consultants, just as we need indices and rating agencies. But at present their main purpose seems to be to allow for the evasion of responsibility. And regulators, and clients, need better data to regulate them.

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